Supreme Court, U. S.
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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1979

* * *

NO. 79-1884

* * *

STATE OF WISCONSIN, STATE OF MINNESOTA, STATE OF TEXAS, and certain designated classes of consumers,

Petitioners,

V.

MELVIN REESE, a trustee in bankruptcy for KENNEDY AND COHEN, INC., and related subsidiary corporations, bankrupts,

Respondent.

* * *

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

* * *

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* * *

The States of Wisconsin and Minnesota, by themselves and on behalf of a designated and approved class of consumers in each of these respective states, and the State of Texas, by itself, respectfully petition the Supreme Court for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit.

OPINIONS DELIVERED IN THE COURTS BELOW

The February 29, 1980 opinion of the United States Court of Appeals for the Fifth Circuit (App. at A-1) is

reported at 612 F.2d 963 (5th Cir. 1980).

The January 30, 1978 opinion of the United States District Court for the Southern District of Florida (App. at A-8) is also reported in part as an appendix to the court of appeals' opinion, *supra*, at 612 F.2d at 964. (App. at A-6).

The May 5, 1977 opinion of the Bankruptcy Court for the United States District Court for the Southern District of Florida (App. at A-11) is also reported in part as an appendix to the court of appeals' opinion, *supra*, at 612 F.2d at 966. (App. at A-1).

JURISDICTION

(i) The United States Court of Appeals for the Fifth Circuit issued and entered its judgment of February 29, 1980 (App. at A-1).

(ii) Petitioners requested no rehearing and no extension of time within which to petition for certiorari.

(iii) 28 U.S.C. §1254(1)(1977) confers jurisdiction of this Court to review cases as this in the court of appeals after rendition of final judgment.

QUESTIONS PRESENTED

1. Must the claims of consumer creditors who have none of the protection or profit expectations of commercial creditors invariably be deferred to those of secured commercial creditors despite the existence of a legitimate and legally valid equitable trust preserving the consumers' funds?

2. Whether the lower court misconstrued and erroneously applied its interpretation of existing bankruptcy law applicable to commercial creditors, to consumer purchasers by ruling that:

a. Consumers who purchased preventive maintenance policies from a retailer by paying

deposits for such contracts must show that any funds in the bankrupt-retailer's possession which the consumers seek to recover for nonperformance of the repair contracts were the *identical* funds paid by the consumer to the bankrupt?

b. A common law equitable lien of constructive trust does not exist in bankruptcy for the benefit of consumer purchasers in the form of a general lien over all the retailer's assets?

STATUTES INVOLVED

Bankruptcy Act of 1898, Ch. 541, §1 et seq., 30 Stat. 544 (1898) [Codified in 11 U.S.C. §101 et seq. (1970)(repealed 1979)]

§1(29a) [11 U.S.C. §1(29a) (1970) (repealed 1979)]

> "Statutory lien" shall mean a lien arising solely by force of statute upon specified circumstances or conditions, but shall not include any lien provided by or dependent upon an agreement to give security, whether or not such lien is also provided by or is also dependent upon statute and whether or not the agreement or lien is made fully effective by statute;

§2a [11 U.S.C. §11a (1970) (repealed 1979)]

> The courts of the United States hereinbefore defined as courts of bankruptcy are hereby created courts of bankruptcy and are hereby invested, within their respective territorial limits as now established or as they may be hereafter changed, with such jurisdiction at law and *in equity* as will enable them to exercise original jurisdiction in proceedings under this Act, in vacation, in chambers, and during their respective terms, as they are now or may be hereafter held to . . . .

(Emphasis supplied)

§64a(4) [11 U.S.C. §104a(4) (1970) (repealed 1979)]

> The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupts estates, and the order of payment shall be . . . .
>
> * * *
>
> (4) taxes which became legally due and owing by the bankrupt to the United States or to any state or any subdivision thereof which are not released by a discharge in bankruptcy: Provided, however, That no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority: And provided further, That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court;

§67c(1) [11 U.S.C. §107c(1) (1970) (repealed 1979)]

> The following liens shall be invalid against the trustee:
>
> (A) every *statutory* lien which first becomes effective upon the insolvency of the debtor, or upon distribution or liquidation of his property, or upon execution against his property levied at the instance of one other than the lienor;
>
> (B) every *statutory* lien which is not perfected or enforceable at the date of bankruptcy against one acquiring the rights of a bona fide purchaser from the debtor on that date, whether or not such purchaser exists: Provided, that where a statutory lien is not invalid at the date of bankruptcy against the trustee under subdivision

c of section 70 of this Act and is required by applicable lien law to be perfected in order to be valid against a subsequent bona fide purchaser, such a lien may nevertheless be valid under this subdivision if perfected within the time permitted by and in accordance with the requirements of such law: And provided further, That if applicable lien law requires a lien valid against the trustee under section 70, subdivision c, to be perfected by the seizure of property, it shall instead be perfected as permitted by this subdivision c of section 67 by filing notice thereof with the court;

(C) every *statutory* lien for rent and every lien of distress for rent, whether statutory or not. A right of distress for rent which creates a security interest in property shall be deemed a lien for the purpose of this subdivision c.

(Emphasis supplied)

Bankruptcy Reform Act of 1978, 11 U.S.C. §101 et seq. (1979), effective October 1, 1979

§402(a)

Except as otherwise provided in this title, this Act shall take effect on October 1, 1979.

§403(a)

A case commenced under the Bankruptcy Act, and all matters and proceedings in or relating to any such case, shall be conducted and determined under such Act as if this Act had not been enacted, and the substantive rights of parties in connection with any such bankruptcy case, matter, or proceeding shall continue to be governed by the law applicable to such case, matter, or proceeding as if the Act had not been enacted.

§507(a)(5)

> The following expenses and claims have priority in the following order:
>
> * * *
>
> (5) Fifth, allowed unsecured claims of individuals, to the extent of $900 for each such individual, arising from the deposit, before the commencement of the case, of money in connection with the purchase, lease, or rental of property, or the purchase of services, for the personal, family, or household use of such individuals, that were not delivered or provided.

§541(c)(2)

> A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title.

§1481

> A bankruptcy court shall have the powers of a court of *equity*, law and admiralty, but may not enjoin another court or punish a criminal contempt not committed in the presence of the judge of the court or warranting a punishment of imprisonment.

(Emphasis supplied)

STATEMENT

This case presents a unique bankruptcy question to the Court of whether the property rights of consumers who prepay for future service contracts to a bankrupt-retailer prior to the bankruptcy should be treated with the same status as commercial creditors in bankruptcy.

The petitioner states and classes of consumers seek to have the Court review a decision of the United States Court of Appeals for the Fifth Circuit which summarily affirmed the lower decisions of the district court and the bankruptcy court. The judgment of the bankruptcy court dismissed the complaints in adversary proceedings in bankruptcy of thousands of consumers for the establishment of a constructive trust in bankruptcy over the assets of the bankrupts.

Prior to the bankruptcy, these consumers had purchased long term preventive maintenance policies from the bankrupts, who were multi-state retail appliance dealers. The policies provided that the consumers would procure repairs for merchandise purchased from the bankrupts only at the bankrupts' service centers. Upon the filing of a Chapter XI petition in bankruptcy, the bankrupts closed their doors in Wisconsin, Minnesota and Texas, as well as all other locations throughout the country, and the consumers' preventive maintenance policies became worthless.

The States of Wisconsin, Minnesota and Texas and their respective consumers claim that the lower courts erred in providing that the proceeds paid by the consumers to the bankrupts for unfulfilled preventive maintenance policies became assets of the bankrupt estate, and were not held in constructive trust for the benefit of these consumers. The preventive maintenance policies now being worthless, those trust funds should have been ordered by the lower courts to be refunded by the trustee in bankruptcy to the consumers.

A. Facts of the Case

Kennedy and Cohen, Inc. and their related subsidiary corporations (hereinafter referred to collectively as "Kennedy and Cohen") were a Miami based household appliance sales organization operating warehouses and retail showrooms in numerous states including Wisconsin, Minnesota and Texas. Throughout their

retail showrooms Kennedy and Cohen sold home appliances and audio video equipment, offered repair services for the merchandise they sold and sold preventive maintenance policies to cover the repairs of the merchandise they sold.

The preventive maintenance policies cost consumers from about $15 to more than $500 and provided repair services from one to five years. Under the terms of these policies, Wisconsin, Minnesota and Texas consumers could bring their merchandise to a Kennedy and Cohen service center for repairs as often as necessary during the policy term for no additional cost. Only the service centers located at the Kennedy and Cohen warehouses in Wisconsin, Minnesota and Texas provided facilities within those states where the consumers of those states could take merchandise for servicing under the preventive maintenance policies.

Immediately upon receipt, Kennedy and Cohen commingled the proceeds from the sale of these preventive maintenance policies with its other funds in its general bank accounts. Kennedy and Cohen used these general accounts to purchase additional inventory and pay other operating expenses. Kennedy and Cohen did not set aside the preventive maintenance proceeds or any other funds or take any other measures to assure the performance of their service policy obligations.

Kennedy and Cohen closed their retail and service center operations within Wisconsin, Minnesota and Texas and filed a Chapter XI bankruptcy petition in the Bankruptcy Court for the United States District Court for the Southern District of Florida in Miami on or about January 20, 1976.

Prior to the date they closed their retail and service center operations, Kennedy and Cohen sold several thousand preventive maintenance policies to Wisconsin, Minnesota and Texas consumers, receiving from these individuals hundreds of thousands of dollars of prepaid

premiums. (In Wisconsin alone, the class of petitioners herein is comprised of over 4,000 consumers who made prepayments of approximately $450,000 for unperformed preventive maintenance policies.) These policies had not expired as of January 20, 1976. As a result of the closing of the service centers within these three states, Kennedy and Cohen could no longer repair their customers' merchandise under the preventive maintenance policies, and the policies became worthless.

The respondent Melvin Reese was appointed by the bankruptcy court to be a receiver in the Chapter XI proceeding. He immediately proceeded to ascertain and gather together all the assets of the debtor, including the general bank accounts of Kennedy and Cohen, into which they had commingled the preventive maintenance policy proceeds. Subsequently, in March, 1976, the Chapter XI proceeding was converted by the bankruptcy court to a straight bankruptcy and the receiver converted to a trustee. Thereafter, the contents of the Kennedy and Cohen stores in Wisconsin, Minnesota, Texas and elsewhere were sold at the trustee's auctions in each of the states to third party purchasers. The proceeds from these auctions were mixed by the trustee into the general bank accounts of the bankrupts.

B. Course of Proceedings and Disposition in the Courts Below

In May of 1976, the States of Wisconsin and Minnesota, together with a consumer in each state who had purchased and was holding one of the unexpired and unfulfilled preventive maintenance policies, commenced a class action adversary proceeding in the Bankruptcy Court for the United States District Court for the Southern District of Florida. The jurisdictional basis for the initiation of this proceeding was 28 U.S.C. §1334 (1975) which confers upon the district court original jurisdiction over all matters and proceedings in

bankruptcy exclusively of the courts of the states. The action was commenced on behalf of all respective Wisconsin and Minnesota consumers similarly situated to recover the money paid by each of them for their unfulfilled preventive maintenance policies. The State of Texas, through its Attorney General, filed a similar complaint in adversary proceedings seeking the recovery of funds for Texas consumers obtained from the sale of preventive maintenance policies by the bankrupts.

The complaints alleged that the bankrupts had sold the preventive maintenance policies with the knowledge that the policies could not have been performed due to Kennedy and Cohen's adverse financial condition and without taking any precautionary measures to assure the performance of the policies. As a result, the complaints maintained that a constructive trust existed in the amount of such proceeds for the benefit of the consumers holding unfulfilled preventive maintenance policies and that the trust funds, not being part of the bankruptcy estate, should be paid to the states on behalf of their consumers prior to all other distributions within the bankruptcy proceedings.

[The maintenance of the class actions of Wisconsin and Minnesota was approved by the bankruptcy court under Bankruptcy Rule 723 in August of 1976. The proceeding by the State of Texas was not in the nature of a class action.]

The answers of the trustee admitted all of the essential allegations of the complaints except for the issue of fraud.

On December 3, 1976, petitioners moved for a summary judgment asserting that *even in the absence of provable fraud*, they were entitled to the imposition of a constructive trust solely on the basis of the wrongdoing of the bankrupts by commingling the proceeds received from the sale of the preventive maintenance policies

with its other assets, failing to undertake any measures to assure performance of these service policy obligations and thereafter failing to perform the repair obligations. The motions thus contended that there was no genuine dispute of material fact between the parties and that a constructive trust existed for the benefit of the appellants as a matter of law.

The petitioners' motions for summary judgment were heard by the bankruptcy court on January 17, 1977, and taken under advisement. Thereafter, the trustee filed his cross motion for summary judgment on February 28, 1977.

On May 5, 1977, the bankruptcy court issued its partial summary judgment in which it issued orders denying the petitioners' motions for summary judgment, granting the trustee's motion for summary judgment, and dismissing without leave to amend and with prejudice those portions of the petitioners' complaints which sought to impose a constructive trust in favor of the purchasers of preventive maintenance policies (App. at A-11).

In the bankruptcy court's written decision, it held that the bankrupts had no duty to segregate the proceeds derived from the sale of preventive maintenance policies or to take any other measures to assure the performance of the policies. The court stated that since there was no evidence of any fraud or other wrongdoing on the part of the bankrupts, no constructive trust could exist. Thus, it held that the unperformed preventive maintenance policies should be treated as any other unperformed executory contract. Moreover, the bankruptcy court held that even if a constructive trust were to be found, it could not be imposed on the general assets of the bankrupts because tracing into an identifiable trust *res* was required under federal law. The court maintained that the preventive maintenance policy proceeds could not be traced and, as a result, no constructive trust could be imposed.

On January 30, 1978, the United States District Court for the Southern District of Florida in Fort Lauderdale affirmed the partial summary judgment of the bankruptcy court (App. at A-8). The district court held that a constructive trust could be imposed against specific assets in appropriate circumstances and that those assets would not become part of the bankrupts' estate. However, the court also held that a constructive trust could not be imposed unless the claimant could trace its funds to an identifiable trust in the hands of the trustee.

The order of the district court was affirmed by the United States Court of Appeals for the Fifth Circuit in New Orleans. In a per curiam opinion (App. at A-1), the court based its decision on the opinions of the district court and the bankruptcy court referred to hereinabove.

REASONS FOR GRANTING THE WRIT

The court of appeals based its decision solely on four reported decisions in refusing to find that the petitioners had properly traced the proceeds received by the bankrupts from the sale of preventive maintenance policies to consumers and in not finding that a constructive trust had been established on their behalfs.

1. Three of these decisions, *In re Faber's, Inc.*, 360 F.Supp. 946 (D.C.Conn. 1973), *Lusk Corporation v. Arizona State Tax Commission*, 462 F.2d 187 (9th Cir. 1972), and *Elliott v. Bumb*, 356 F.2d 749 (9th Cir.), *cert. denied*, 385 U.S. 829 (1966), were in direct conflict with the applicable decisions of this Court as to the issue of "tracing" in *Cunningham v. Brown*, 265 U.S. 1, 12 (1924), and *Central National Bank v. Insurance Company*, 104 U.S. 54 (1881).

2. The same three decisions are in conflict with more recent decisions of another court of appeals in *Selby v. Ford Motor Company*, 590 F.2d 642 (6th Cir. 1979), and *In the Matter of Federals, Inc.*, 553 F.2d 509 (6th Cir.

1976), concerning the issue of establishing a constructive trust in bankruptcy.

3. The fourth decision relied upon by the lower courts herein, *United States v. Randall*, 401 U.S. 513 (1971), was improperly applied and has been modified or overruled by §541(c)(2) of the Bankruptcy Act of 1978, 11 U.S.C. §541(c)(2) (1979).

4. *In re Faber's, Inc., supra*, as well as all the lower courts in the instant case, have decided an important question of federal law -- the property rights of consumer purchasers in bankruptcy -- which has not been, but should be, settled by this Court in order to make a clear distinction between consumer property rights and the rights of commercial creditors in bankruptcy.

1. The holding of the courts below that a constructive trust cannot be recognized unless the funds are traced to specific assets of the bankrupt was contrary to prior decisions of this Court authorizing such trusts over money traced into general bank accounts of the bankrupt.

The lower courts in this matter, whose decisions were incorporated by the court of appeals, erroneously determined that although some state law may not require that funds be traceable to specific assets in order to establish a constructive trust in bankruptcy, such state law must yield to federal law and policy which requires specific tracing. Thus the bankruptcy court at App. A-4 and A-14-15, stated that:

> Plaintiffs argue that the notion that funds must be traceable and the requirement that the res be identifiable are concepts of purely historical interest today, at least in the *enlightened* states of Wisconsin, Minnesota and Texas . . . . However, it is a federal question whether a trust, whether expressed or constructive,

> which cannot be traced to specific assets, will attach to the creditors' general funds in bankruptcy.

(Emphasis supplied)

The district court also held at App. A-6-7 and A-9, that:

> Under federal law, plaintiffs must be able to trace their funds to an identifiable trust in the hands of the trustee. . .Insofar as state law is to the contrary, it must yield to federal policy.

In fact, it was state law based upon *United States Supreme Court law* which held that even in bankruptcy proceedings, funds need only be traced into the general funds held by the bankrupts or trustee.

The clear determination on this matter, which has not been overruled or modified by the Supreme Court, is *Cunningham v. Brown*, 265 U.S. 1 (1924). In that case, a Mr. Ponzi had defrauded numerous consumers out of funds for the purchase of international postal coupons and placed all the funds in a general bank account. This embezzler had commingled numerous funds in and out of the bank account, had depleted it many times and had made other deposits into it. After Mr. Ponzi declared bankruptcy, many of the persons defrauded attempted to establish a constructive trust over their monies paid into the bank accounts by tracing and identifying their funds into the bankrupts' general bank accounts.

This Court, in *not* requiring specific identification of the proceeds paid into the bank account, cited a number of earlier decisions including *Central National Bank v. Insurance Company*, 104 U.S. 54 (1881), and even Engligh common law in *Knatchbull v. Hallett*, L.R. 13 Ch.D. 696 (English Court of Appeals). The Supreme Court then held:

> Where a fund was composed partly of a defrauded claimant's money and partly of that of

> the wrongdoer, it would be presumed that in the fluctuations of the fund it was the wrongdoer's purpose to draw out money he could legally and honestly use rather than that of the claimant, and that the claimant might identify what remained of his *res* and assert his right to it by way of an equitable lien on the whole fund, or a proper pro rata share of it.

265 U.S. at 12.

This holding has been followed and utilized consistently since the *Cunningham* case in numerous decisions to find that a bank account impressed with a trust may be traced into a fund of commingled money. *See In re Kountze Brothers, et al.*, 79 F.2d 98 (2nd Cir. 1932), *cert. denied sub nom. Irving Trust Company v. Los Angeles*, 296 U.S. 640 (1935), and such recent cases as *Liberty National Life Insurance Company v. U.S.*, 463 F.2d 1027 (5th Cir. 1972), *Universal CIT Credit Corp. v. Farmers Bank of Portageville*, 358 F.Supp. 317 (E.D. Mo. 1973), *Brown and Williamson Tobacco Company v. First National Bank of Blue Island*, 504 F.2d 998 (7th Cir. 1974), and *Michigan National Bank v. Flowers Mobile Home Sales, Inc.*, 26 N.C. App. 690, 217 S.E.2d 108 (1975).

In the instant case, the petitioners indisputably traced the proceeds of the preventive maintenance policies received by the bankrupts into the bankrupt's general bank accounts. Accordingly, under *Cunningham v. Brown, supra*, the funds were traced to an identifiable *res* in the hands of the trustee. The lower courts in the instant case were in error in relying upon the cases of *In re Faber's, Inc.*, 360 F.Supp. 946 (D.C. Conn. 1973), *Lusk Corporation v. Arizona State Tax Commission*, 462 F.2d 187 (9th Cir. 1972), and *Elliott v. Bumb*, 356 F.2d 749 (9th Cir.), *cert. denied*, 385 U.S. 829 (1966), for the proposition that imposing a trust upon a general bank account would result in a state created priority contrary to federal bankruptcy law. The funds in the instant case

were traced to an identifiable *res*, and thus the trust does not fall within the bankruptcy's priority scheme.

That there was sufficient wrongdoing by the bankrupts for the establishment of a constructive trust is discussed in section four of this petition, *infra*. The court of appeals, by requiring tracing into more specific assets, clearly was in conflict with this Court's applicable decisions. The court of appeals decision should, therefore, be reviewed and reversed.

2. The cases relied upon by the court of appeals in its instant decision apply only to statutory trusts established after the enactment of the Bankruptcy Act, and conflict with more recent court of appeals' decisions relating to the validity of equitable trusts in bankruptcy, such as a constructive trust, which preceded the enactment of the Bankruptcy Act.

The lower courts in this matter relied primarily upon *Lusk Corp. v. Arizona State Tax Commission*, *supra*, and *Elliott v. Bumb*, *supra*. Those cases dealt with state statutes which created trusts over withheld income tax and commingled money order deposits, respectively. Certain creditors in each case sought to have these statutory trust imposed in bankruptcy. The ninth circuit, in *Elliott v. Bumb*, *supra* and *Jaffke v. Dunham*, 352 U.S. 280, 281 (1957), acknowledged that the question of whether a trust is established is to be resolved by the application of state law. However, the court in each of those cases said that such *statutory* trusts were in conflict with §67c(1) of the Bankruptcy Act of 1898, Ch. 541, §67, 30 Stat. 564 (1898) [Codified in 11 U.S.C. §107(c)(1) (1970) (repealed 1979)] in which only a "statutory lien" is invalid against the trustee, and as such would again be a disguised priority in bankruptcy.

In contrast, the constructive trust lien in bankruptcy which petitioners seek to be imposed is *not* a statutory lien; it is an *equitable, common law* lien which has been

well established historically by nearly every state (including Wisconsin, Minnesota and Texas, as well as Florida where the bankrupts were domiciled) prior to the enactment of the Bankruptcy Act.

In *In the Matter of Federals, Inc.*, 553 F.2d 509 (6th Cir. 1976), the sixth circuit upheld a Uniform Commercial Code provision that granted to the seller of goods reclamation rights against the bankrupt buyer as superior to the rights of the bankrupt's other creditors because the statute was well founded historically in the common law and in equity.

> Nevertheless, we are persuaded that the rights asserted by the seller under §2-702(2) is a valid state created right of ownership. Because that right conceptually has its antecedence in the historical and equitable rights of a defrauded seller to reclaim the goods he has sold to an insolvent buyer, we hold it cannot be said to arise "*solely* by force of statute" under §1(29)[*sic*] [11 U.S.C. §1(29a)(1970)(repealed 1979)].

553 F.2d at 516.

Similarly, in *Selby v. Ford Motor Company*, 590 F.2d 642 (6th Cir. 1979), the sixth circuit upheld a statutory trust for building subcontractors in bankruptcy, disallowing the efforts of a trustee in bankruptcy to appropriate those funds for the benefit of general creditors, on the grounds that the state law creating the trust *preexisted* the enactment of the bankruptcy provisions placing restrictions on such devices.

Since a constructive trust is also a state created equitable lien historically rooted in the common law long before the enactment of the bankruptcy laws, the court of appeals in the instant case erroneously applied the cases it cited and was in conflict with the *Federals* and *Selby* court of appeals cases, *supra*.

3. The only Supreme Court case relied upon by

the court of appeals, dealing with a specific Bankruptcy Act priority provision in 1971, was not only non-applicable to the instant case, it has been subsequently overruled by the Bankruptcy Reform Act of 1978.

The court of appeals and lower courts cited and relied upon this court's 1971 decision in *United States v. Randall*, 401 U.S. 513 (1971), for the proposition that common law constructive trust doctrine must yield to specific federal bankruptcy law provisions. In *Randall, supra*, the United States also attempted to have a *statutory* constructive trust established in bankruptcy for the recovery of taxes wrongfully not withheld by the bankrupt. This Court correctly held that a statutory trust could not be maintained in the case, because it would be in conflict with the specific priority which §64a(4) of the Bankruptcy Act of 1898, as amended, gave to tax claims owed to the United States (Bankruptcy Act of 1898, Ch. 541, §64, 30 Stat. 563 (1898) [Codified in 11 U.S.C. §11(a) (1970) (repealed 1979)]. Since the Bankruptcy Act of 1898, as amended, specifically placed these special tax claims into designated order in the bankruptcy scheme, that statutory priority governed even generalized statutes giving the government a priority in a wide range of situations.

In the instant case, however, consumers who prepaid for services had no statutory priority; the Bankruptcy Act of 1898, as amended, did not deal with these claims at all. Therefore, a common law constructive trust doctrine could not conflict with a non-existent bankruptcy act provision, and the court's decision in *Randall, supra*, was flagrantly misapplied.

Furthermore, *Selby v. Ford Motor Company, supra*, 590 F.2d at 648 note 18, states that Section 541(c)(2) of the Bankruptcy Reform Act of 1978 [11 U.S.C. §101 et seq. at §541(c)(2) (1979)] recognizing trust interests created by state law, was intended to modify or overrule

the holding in *Randall, supra*, according to the legislative history set forth by the sixth circuit. Thus the reliance on *Randall, supra* is additionally misplaced.

4. The court of appeals, as well as all the decisions it relied upon, decided an important question of federal law, the nature of the property rights of consumer purchasers in bankruptcy, erroneously utilizing the law applicable to commercial creditors in bankruptcy, which question has not been, but should be, settled by this Court.

Although the rights of commercial creditors in bankruptcy have been well developed in hundreds of reported decisions arising from bankruptcy proceedings, the property rights of consumers who prepay for future goods or services and then present their claims in bankruptcy court to recover these prepayments on account of nondelivery of merchandise or nonperformance of service have not been substantially addressed by the courts.

The only pertinent case relied upon by the court of appeals in the instant matter was *In re Faber's, Inc., supra*. In that case certain consumers had made cash deposits to a carpet dealer for the future delivery of carpets. When the dealer went bankrupt, the plaintiffs sought to have a constructive trust imposed upon the deposits which had been commingled by the realtor in his general bank accounts.

The court in *Faber, supra*, noted that Connecticut would normally allow a constructive trust to exist under these circumstances, and cited a sympathetic law review article which dealt with the distinction between consumer purchasers and commercial creditors in bankruptcy. Schrag and Ratner, *Caveat Emptor-Empty Coffer: The Bankruptcy Law Has Nothing To Offer*, 1972 Columbia L. Rev. 1147. However, then the district court relied upon the previously discussed cases of *Elliott v. Bumb, supra, Lusk Corp. v. Arizona State Tax Commission, supra*, and *United States v. Randall,*

supra, all dealing with *commercial creditors* in bankruptcy, to deny the consumers' constructive trust in that bankruptcy.

In essence, no previously cited case has dealt with the serious and substantial differences between consumer purchasers and commercial creditors in bankruptcy. That distinction has created such burdensome and inequitable results as to warrant consideration by this Court.

That a constructive trust could be imposed in the instant case is clear. The keystone case is *In re Mid-Center Redevelopment Corp.*, 383 F.Supp. 954 (N.J. 1974). There the federal district court overruled the bankruptcy judge's denial of the imposition of a constructive trust and found the law of New Jersey would impose such a trust despite a lack of showing of actual or constructive fraud. The district court stated:

> [A] constructive trust will be impressed in any case where to fail to do so will result in unjust enrichment [cases cited]. Generally, all that is required to impose a constructive trust is a finding that there was some wrongful act usually though not limited to, fraud, mistake, undue influence, or breach of a confidential relationship, which has resulted in a transfer of property . . . [citing 4 Scott §462.2]. It may be said that a constructive trust will be impressed in any case where to fail to do so will result in an unjust enrichment and where there has been a transfer of property as a result of some wrongful act (*which need not be fraudulent in nature*). . . .

383 F.Supp. at 972

(Emphasis supplied).

In the instant case, the district court, at App. A-6 and A-9, stated:

> [T]he court agrees with appellant that constructive trusts recognized by state law may be imposed against specific assets in appropriate circumstances, and those assets do not become part of the bankrupt's estate . . . .

These "appropriate circumstances" would be the wrongdoings of the bankrupts, *despite the absence of fraud.* The wrongdoings consisted of the bankrupts' breach of their duty either to segregate the proceeds received from consumers from the sale of preventive maintenance policies or to take other steps to provide protection and assure the performance of the preventive maintenance policies.

The reasoning of all the courts in the past has been that consumers who purchase preventive maintenance policies should be treated as any other commercial creditors who lend money to a debtor. That means in the instant situation, that for the consumers to have protected themselves in the event of nonperformance of their prepaid preventive maintenance policies, they should have, at the time of sale, (a) demanded a security interest in Kennedy and Cohen's inventory and bank accounts as other secured creditors did or (b) required Kennedy and Cohen to escrow the proceeds derived from the sale of the preventive maintenance policies for the protection of the policies. Since the consumers did not take these steps, which prudent commercial creditors would have taken, the court of appeals held that the consumers were merely general creditors and the unfulfilled preventive maintenance policies would be treated as rejected executory contracts.

This reasoning creates a gross injustice. Although the consumers may be held to the standard of commercial creditors in bankruptcy proceedings, at the time of sale of the preventive maintenance policies Kennedy and Cohen, like all commercial entities, would not permit consumers to avail themselves of any of the normal protections demanded by commercial creditors.

Despite the *theoretical* right of all parties to bargain, such protections were never truly available to consumers. If a consumer, even a sophisticated attorney consumer, were to go into Penny's, Sears, or any other retail establishment which sells prepaid service policies on its merchandise and were to demand a security interest in assets or the escrowing of his prepaid funds in order to protect his "investment" in a service policy, he would be told to buy elsewhere. No retailer, Kennedy and Cohen included, would sell any prepaid maintenance policies to a consumer under those conditions. Thus, the inability of these consumers to take such protections should not be used to disable them in bankruptcy.

Such an estoppel argument was recently confirmed by the ninth circuit in *In re Bruce Farley Corporation, bankrupts; Star v. Bruce Farley Corporation*, 612 F.2d 1197 (9th Cir. 1980). There a creditor was unable to perfect certain promissory notes and deeds of trust because the bankrupt debtor refused to relinquish possession of the instruments. A security interest in such instruments could only be perfected by the secured party's taking possession. The court of appeals said:

> Finally, appellee argues that even if a constructive trust might otherwise be available, the policy of the Bankruptcy Act is adverse to the recognition of such a claim in bankruptcy where the party making such a claim failed to comply with available procedures for perfecting a legal lien .... Whatever the validity of this argument in other contexts, it cannot apply when the party was *prevented* from taking possession and thus *perfecting his legal lien* by the very *wrongful* detention which is the *grounds for the claim for relief based upon constructive trust.* To hold otherwise would leave the parties in appellants' position no way to protect themselves short of filing an action to recover possession of the instrument.

612 F.2d at 1201 (emphasis supplied).

Similarly, Kennedy and Cohen did not permit any of the consumer purchasers to perfect their interests or take possession of the down payment through an escrow requirement. The consumers had none of the protections available to commercial creditors and the Fifth Circuit Court of Appeals erred below by holding such consumers to the standard of care demanded of commercial creditors.

The consumers here did not deal in a commercial arms length relationship with Kennedy and Cohen. Unlike commercial creditors, consumers did not operate with an eye on profit and an awareness of risk of loss. Additionally, the consumers were not lenders nor were the prepayments they made for the purchase of preventive maintenance policies considered as loan funds. Kennedy and Cohen paid no interest to the consumers for the monies received in advance. Nevertheless, Kennedy and Cohen readily commingled these funds with their general accounts and used them to pay their secured and other creditors. Of course, the consumers never understood that their monies would be used for any purpose other than the performance of preventive maintenance policy obligations.

This course of dealing and the expectations it engendered among the consumers lead to the creation of a duty by Kennedy and Cohen to take some action to assure the performance of the preventive maintenance policies. This duty did not arise with respect to commercial creditors who could provide for their own protection in ways described. Since Kennedy and Cohen took no precautions to insure the performance of the preventive maintenance policy obligations, they breached their duty. The breach of this duty constituted wrongdoing necessary for the imposition of a constructive trust within the standard of *In re Mid-Center Redevelopment Corp., supra.*

A business which lends money, advances credit or ships merchandise to another is familiar with the risks involved and knows of the legal protections available. It has had an opportunity to investigate the reliability and solvency of the firm or persons with whom it is dealing. Moreover, it has entered into a transaction with the express intent of making a profit. Any investment made in hopes of profits carries with it the inherent, necessary, and well understood risk of loss. In any commercial business transaction the parties deal with the mutual understanding of the everyday possibility of gain or loss, upon which they both must calculate and compromise.

In contrast, the consumer who pays money for a long term service contract or for the future delivery of merchandise has no such understanding of risk or profit in the transaction; he just wants to get his service or merchandise. The parties to a consumer transaction implicitly agree that money is given to the merchant for holding until the service is performed or the ordered merchandise is delivered. If the merchant fails to perform, the consumer also understands that all monies paid will be returned.

This is the critical distinction in this case. The courts have used inappropriate standards applicable to commercial creditors to reach absurd results regarding consumer purchases.

In the Bankruptcy Reform Act of 1978, 11 U.S.C. §507(a)(5) (1979), Congress has confirmed that such a distinction exists by creating a limited consumer priority for bankruptcies occurring after October 1, 1979. In this new provision, consumer purchasers who prepay retailers for future merchandise or services will have a fifth priority in bankruptcy as unsecured claimants if the merchandise or service is not provided. Thus the special status accorded to consumer purchasers, although not recognized by the lower courts, has been given recognition by Congress.

Although the status of consumer purchasers has been legislatively acknowledged, the specific provision contained in §507(a)(5) of the Bankruptcy Reform Act of 1978, *supra*, is not applicable to the instant bankruptcy, which occurred in 1976. [11 U.S.C. §§402(a) and 403(a) (1979)]. Likewise, quite obviously, it does not apply to any bankruptcy declared either in the past or in the future, in which there are no unsecured assets.

In the instant case, the petitioners seek that a constructive trust be imposed on all the assets of the bankruptcy estate, most of which have been either secured or consumed by the administrative expenses. Thus, the bankruptcy court, at App. A-3 and A-13, noted:

> This feature of plaintiffs' case assumes practical significance, because it presently appears that little if anything will be available for distribution to the general creditors in this case.

The key point is that there is a validly recognized distinction between the petitioner-consumer purchasers and the other commercial creditors in this bankruptcy, which should have been utilized by the lower courts in the instant case to establish a constructive trust over *all* the assets in the respondent's possession. The bankruptcy court, which is and has always been a statutory court of equity, had the power to invoke such a remedy. Section 2a of the Bankruptcy Act of 1898, as amended (Bankruptcy Act of 1898, Ch. 541, §2, 30 Stat. 545 (1898) [Codified in 11 U.S.C. §11(a) (1970) (repealed 1979)].

In order to place this critical difference in its proper perspective and to correct the substantial injustice of the court of appeals' decision in the instant case, the Court should review this case.

CONCLUSION

For the reasons set forth above, we respectfully urge that this petition for a writ of certiorari to the United States Court of Appeals for the Fifth Circuit be granted.

Respectfully submitted,

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APPENDIX

APPENDIX

OPINION OF THE COURT OF APPEALS

In the Matter of KENNEDY & COHEN, INC., et al.

STATE OF WISCONSIN et al.,
Plaintiffs-Appellants,

v.

Melvin REESE, Trustee, et al.,
Defendants-Appellees.

No. 78 - 1545.

United States Court of Appeals,
Fifth Circuit.

Feb. 29, 1980.

Appeal from the United States District Court for the Southern District of Florida.

Before THORNBERRY, RONEY and TATE, Circuit Judges.

PER CURIAM:

AFFIRMED on the basis of the unreported opinions of the district court, dated January 30, 1978, and the bankruptcy court, dated May 5, 1977, the relevant portions of which are attached hereto as an appendix.

APPENDIX

PARTIAL SUMMARY JUDGMENT *of Bankruptcy Court dated May 5, 1977*

The case is here on motions for summary judgment filed by the plaintiffs and by the trustee in three

adversary proceedings, which though not identical are sufficiently similar to be resolved together. The complaints were dismissed as to all counts except Count I. (C.P. No. 2881).

The cases are class actions seeking money damages from the trustee for customers of the bankrupt, a retailer of various appliances in various parts of Florida and several other states. The remaining count seeks (a) recovery of fees paid for maintenance contracts which cannot be performed, . . .

The major element in these actions is the first claim, for unperformed maintenance contracts. The bankrupt for some two years had accepted payment of from $50 to $300 from many customers in return for a commitment to repair specified merchandise for periods that varied from nine months to five years. As a result of bankruptcy liquidation, many of the contracts cannot be performed.

It is plaintiffs' theory that the bankrupt was under a legally implied duty to segregate these fees in order to ensure that funds would be available to perform these contracts. It is admitted that there was no express trust created by contract or statute. It is plaintiffs' alternative argument that, at some point to be fixed by proof, the bankrupt knew it would not be able to perform these contracts yet continued to sell them after that point.

Plaintiffs seek the imposition of a constructive trust by this court upon all the assets of the bankrupt for the satisfaction of these claims. Property held by a bankrupt in trust belongs to the beneficiary and never becomes a part of the bankruptcy estate. 4A *Collier on Bankruptcy* (14th ed.) Section 70.25(2). Such a holding would, therefore, entitle plaintiffs' classes to priority in payment as to all the assets of the bankrupt, ahead of the claims of creditors who have valid security interests, ahead of the administrative costs and expenses incurred in this court and ahead of all other priority and general

creditors.

The feature of plaintiffs' case assumes practical significance, because it presently appears that little if anything will be available for distribution to the general creditors in this case. Distribution cannot be calculated or made until this litigation is concluded.

Plaintiffs have moved for summary judgment . . . .

The trustee has also moved for a summary judgment. (C.P. No. 1299I) The motion is addressed solely to those portions of the Wisconsin complaint (paragraphs 1-18, first claim for relief) and the Minnesota complaint (paragraphs 1-21, first claim for relief) and the Texas complaint (third claim for relief) dealing with maintenance contracts. The motion is granted.

A constructive trust is a tool of equity to prevent unjust enrichment. Its applicability to any part of the estate of this bankrupt requires that one of the plaintiffs establish some wrongdoing on the bankrupt's part either in *obtaining* the funds sought or in *retaining* them, if they were properly obtained. The degree of actual or constructive fraud required appears to change at state boundaries and with the pasage of time.

I reject the argument that the sales of maintenance contracts, without more, creates a legal duty to segregate the funds received for that purpose and imposes a constructive trust upon them. I believe that it still remains a legislative and not a judicial prerogative to mandate such a duty.

The record before me negatives any allegation that the bankrupt knew before bankruptcy that it could not perform these contracts, therefore, sold them fraudulently. The record negatives any other suggestion of actual or constructive fraud or wrongdoing which might support a constructive trust.

. . . . . .

. . . The maintenance contracts of this debtor were not legally different from any other executory contract made by this bankrupt which has been frustrated by its financial collapse and bankruptcy.

. . ., [F]rom the record before me it is established that there is no identifiable trust res to which the asserted constructive trust could attach. Plaintiffs cannot trace the funds that were paid for these contracts. Plaintiffs argue that the notion that funds must be traceable and the requirement that the res be identifiable are concepts of purely historical interest today, at least in the enlightened states of Wisconsin, Minnesota and Texas. There are decisions that support this contention of the plaintiffs, at least in certain contexts. However, it is a federal question whether a trust, whether express or constructive, which cannot be traced to specific assets, will attach to the creditors' general funds *in bankruptcy.*

In *United States v. Randall,* 401 U.S. 513, 91 S.Ct. 991, 28 L.Ed.2d 273 (1971) the Court held that the Bankruptcy Act is an overriding expression of federal policy which precludes the imposition of a constructive trust in favor of the I.R.S. against bankruptcy assets, even where the ingredients for a constructive trust are present.

In *Elliott v. Bumb,* 9 Cir. 1966, 356 F.2d 749, 754-755, *cert. den.* 385 U.S. 829, 87 S.Ct. 67, 17 L.Ed.2d 66 (1966), a California vendor of money orders became bankrupt. A California statute required that the vendor segregate all payments received and, if the vendor failed to do so, the statute impressed a statutory trust on all funds of the vendor needed to honor the money orders. The bankrupt did not segregate enough and the court held that the holders of the money orders in excess of traceable funds were general creditors of the bankrupt and were entitled to no priority or other special consideration ahead of any other creditors.

The court concluded that the state statute insofar as it

undertook to impress a lien upon general funds of the debtor, in effect, created a statutory lien in favor of a particular class of creditors. Section 67c(2) of the Bankruptcy Act has invalidated all statutory liens, except rent. Section 64a(1)-(5) explicitly orders the priorities. The Supremacy Clause requires that conflicting state law give way to these provision.

The court quoted and followed a similar statement of the rule announced at 4A *Collier on Bankruptcy* (14th ed.) Section 70.25(2).

This decision is controlling in our cases. There is no reason that a constructive trust which is imposed by State case law, assuming that to be the situation here, would warrant a different conclusion from that reached in *Elliott*, which dealt with an express trust imposed by State statute. In the words of the court:

> If state law is contrary to federal bankruptcy law, the state law must yield. Giving effect to the provisions of Section 12300.3, which would impress a trust upon commingled funds, would open the door to state creation of priorities in favor of various classes of creditors by labeling such priorities as "trusts". This would tend to thwart or obstruct the scheme of federal bankruptcy.

Elliott was followed in *Lusk Corp. v. Arizona State Tax Commission*, 9 Cir. 1972, 462 F.2d 187, dealing with income taxes withheld but not segregated and not traceable. It was also followed in *In re Faber's, Inc.*, D.Conn. 1973, 360 F.Supp. 946, 948 dealing with a rug company which diverted the deposits of customers made for rugs promised but not delivered. The court recognized that a constructive trust, at least in Connecticut must be based upon "fraud, actual or constructive" and it was unlikely that this element was present, but even if it were, the court concluded:

> The courts have consistently treated the distributional priorities created by the Bankruptcy Act as a paramount congressional policy which must predominate in the face of conflicting state or even federal law.

It then cites and follows *United States v. Randall, Elliott v. Bumb,* and 4A *Collier on Bankruptcy* (14th ed.) Section 70.25(2) pp. 363-364 reviewed above.

Those portions of the three complaints filed for customers in Wisconsin, Minnesota and Texas which seek to impress a trust in favor of certain purchasers of maintenance contracts are dismissed without leave to amend and with prejudice.

ORDER of District Court dated January 30, 1978

Several appeals are currently pending before this court. The principal appeal is that of the States of Wisconsin, Minnesota and Texas from the order of the bankruptcy court entered May 5, 1977 granting partial summary judgment in favor of the trustee. Because it is dispositive of the remaining appeals the court will consider it first.

Upon review of the record and arguments of counsel, the court concludes that the order of the bankruptcy court must be affirmed. The court agrees with appellant that constructive trusts recognized by state law may be imposed against specified assets in appropriate circumstances, and those assets do not become part of the bankrupt's estate. *See* 4A *Collier on Bankruptcy* (14th ed.) § 70.25(2). However, the court cannot agree with appellants' argument that they need not identify specific trust assets in order for the trust to be imposed. The question of whether a constructive trust, which cannot be traced to specific assets, will attach to general funds held by the Trustee in Bankruptcy is a matter of federal law. Under federal law, plaintiffs must be able

to trace their funds to an identifiable trust in the hands of the trustee. *Elliott v. Bumb*, 356 F.2d 749 (9th Cir.), *cert. denied*, 385 U.S. 829, 87 S.Ct. 67, 17 L.Ed.2d 66 (1966); *In re Faber's, Inc.*, 360 F.Supp. 946 (D.Conn.1973). Insofar as state law is to the contrary, it must yield to federal policy. *United States v. Randall*, 401 U.S. 513, 91 S.Ct. 991, 28 L.Ed.2d 273 (1971).

ORDER OF THE DISTRICT COURT

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA

In the Matter of:	§	
	§	
KENNEDY & COHEN, INC., et al.,	§	
	§	
Bankrupt.	§	76-97-BK-B-NCR
	§	
	§	
STATE OF WISCONSIN, et al.,	§	
	§	
Plaintiff,	§	
	§	ORDER
V.	§	
	§	
MELVIN REESE, trustee, et al.,	§	
	§	
Defendants,	§	
	§	
STATE OF MINNESOTA, et al.,	§	
	§	
Plaintiff,	§	
V.	§	
	§	
MELVIN REESE, trustee, et al.,	§	
	§	
Defendants	§	
	§	
STATE OF TEXAS, et al.,	§	
	§	
Plaintiff,	§	
	§	
V.	§	
	§	
MELVIN REESE, trustee, et al.,	§	
	§	
Defendants.	§	
	§	

Several appeals are currently pending before this court. The principle appeal is that of the States of Wisconsin, Minnesota and Texas from the order of the

bankruptcy court entered May 5, 1977 granting partial summary judgment in favor of the trustee. Because it is dispositive of the remaining appeals the court will consider it first.

Upon review of the record and arguments of counsel, the court concludes that the order of the bankruptcy court must be affirmed. The court agrees with appellant that constructive trusts recognized by state law may be imposed against specified assets in appropriate circumstances, and those assets do not become part of the bankrupts' estate. See: 4A Collier on Bankruptcy (14th Ed.) §70.25(2). However, the court cannot agree with appellants argument that they need not identify specific trust assets in order for the trust to be imposed. The question of whether a constructive trust, which cannot be traced to specific assets, will attach to general funds held by the Trustee in Bankruptcy is a matter of federal law. Under federal law, plaintiffs must be able to trace their funds to an identifiable trust in the hands of the trustee. *Elliot v. Bumb*, 356 F.2d 749 (9th Cir. 1966) [sic]; In Re: *Faber's Inc.* 368 F.Supp. 946 (D. Conn. 1973). Insofar as state law is to the contrary, it must yield to federal policy. *U.S. v. Randall*, 401 513 (1971) [sic]. Turning now to the remaining appeals of Wisconsin and Minnisota [sic] from certain discovery orders entered by the bankruptcy court, the court finds that the discovery dispute arises out of appellants attempt to prove fraud as a necessary element of the constructive trust doctrine. In view of this court's disposition of the appeal from the grant of partial summary judgment, the remaining appeals are moot. Accordingly it is

ORDERED AND ADJUDGED that the order of the bankruptcy court granting partial summary judgment in favor of the trustee is hereby affirmed in all respects, it being

FURTHER ORDERED AND ADJUDGED that the appeals of appellants Wisconsin and Minnisota [sic] filed August 23, 1976 and September 23, 1976 are hereby dismissed as moot.

DONE AND ORDERED this *30* day of *January* 1978.

United States District Court
Judge

ORDER OF THE BANKRUPTCY COURT

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA
CASE NO. 76-97-BK-NCR-B

In the Matter of:	§	
	§	
KENNEDY & COHEN, INC., et al.,	§	
	§	
Bankrupt.	§	
	§	
	§	
STATE OF WISCONSIN, et al.,	§	
	§	
Plaintiff	§	PARTIAL SUMMARY
	§	JUDGMENT
v.	§	
	§	
MELVIN REESE, trustee, et al.,	§	
	§	
Defendants,	§	
	§	
STATE OF MINNESOTA, et al.,	§	
	§	
Plaintiff	§	
	§	
v.	§	
	§	
MELVIN REESE, trustee, et al.,	§	
	§	
Defendants,	§	
	§	
STATE OF TEXAS, et al.,	§	
	§	
Plaintiff,	§	
	§	
v.	§	
	§	
MELVIN REESE, trustee, et al.,	§	
	§	
Defendants.	§	
	§	
	§	

The case is here on motions for summary judgment filed by the plaintiffs and by the trustee in three adversary proceedings, which though not identical are sufficiently similar to be resolved together. The complaints were dismissed as to all counts except count I. (C.P. No. 288I)

The cases are class actions seeking money damages from the trustee for customers of the bankrupt, a retailer of various appliances in various parts of Florida and several other states. The remaining count seeks (a) recovery of fees paid for maintenance contracts which cannot be performed, (b) the purchase price of lay away merchandise, which cannot now be delivered and (c) the value of items brought in for repairs, which have been sold by the trustee and therefore cannot be returned to the customers.

The major element in these actions is the first claim, for unperformed maintenance contracts. The bankrupt for some two years had accepted payment of from $50 to $300 from many customers in return for a commitment to repair specified merchandise for periods that varied from nine months to five years. As a result of bankruptcy liquidation, many of the contracts cannot be performed.

It is plaintiffs' theory that the bankrupt was under a legally implied duty to segregate these fees in order to insure that funds would be available to perform these contracts. It is admitted that there was no express trust created by contract or statute. It is plaintiffs' alternative argument that, at some point to be fixed by proof, the bankrupt knew it would not be able to perform these contracts yet continued to sell them after that point.

Plaintiffs seek the imposition of a constructive trust by this court upon all the assets of the bankrupt for the satisfaction of these claims. Property held by a bankrupt in trust belongs to the beneficiary and never becomes a part of the bankruptcy estate. 4A *Collier on*

Bankruptcy (14th ed.) Section 70.25(2). Such a holding would, therefore, entitle plaintiffs' classes to priority in payment as to all the assets of the bankrupt, ahead of the claims of creditors who have valid security interests, ahead of the administrative costs and expenses incurred in this court and ahead of all other priority and general creditors.

This feature of plaintiffs' case assumes practical significance, because it presently appears that little if anything will be available for distribution to the general creditors in this case. Distribution cannot be calculated or made until this litigation is concluded.

Plaintiffs have moved for summary judgment as to liability upon all their surviving claims. (C.P. No. 1157I) The motions are denied. Plaintiffs have assumed that this court's refusal to dismiss their first count constituted a ruling upholding the entire count. This was not the case. I denied the motion to dismiss as to the first count, because that count also sought relief from the trustee as to lay away merchandise and items brought in for repairs. The trustee conceded the sufficiency of these claims.

The trustee has also moved for a summary judgment. (C.P. No. 1299I) The motion is addressed solely to those portions of the Wisconsin complaint (paragraphs 1-18, first claim for relief) and the Minnesota complaint (paragraphs 1-21, first claim for relief) and the Texas complaint (third claim for relief) dealing with maintenance contracts. The motion is granted.

A constructive trust is a tool of equity to prevent unjust enrichment. Its applicability to any part of the estate of this bankruptcy requires that one of the plaintiffs establish some wrong doing on the bankrupt's part either in *obtaining* the funds sought or in *retaining* them, if they were properly obtained. The degree of actual or constructive fraud required appears to change at state boundaries and with the passage of time.

I reject the argument that the sale of maintenance contracts, without more, creates a legal duty to segregate the funds received for that purpose and imposes a constructive trust upon them. I believe that it still remains a legislative and not a judicial prerogative to mandate such a duty.

The record before me negatives any allegation that the bankrupt knew before bankruptcy that it could not perform these contracts, therefore, sold them fraudulently. The record negatives any other suggestion of actual or constructive fraud or wrong doing which might support a constructive trust.

The first two of these complaints have now been pending almost a year and the plaintiffs have shared their discovery and investigation with those who followed them. During argument before me last July on plaintiff's motions, I was told by plaintiffs that discovery could be completed by September, 1976. Another half year has elapsed. There is no affidavit or motion before me from any plaintiff under Rule 56(f), F.R.Civ.P. (applicable here under B.R. 756) seeking a continuance to obtain support for the allegations. It would seem that more than ample time has been afforded plaintiffs to be able to counter the trustee's motion and they have failed to do so.

I conclude, as the trustee has argued, that there has been no wrong doing here of the character that would support a constructive trust on behalf of the plaintiffs. The maintenance contracts of this debtor were not legally different from any other executory contract made by this bankrupt which has been frustrated by its financial collapse and bankruptcy.

Secondly, from the record before me it is established that there is no identifiable trust res to which the asserted constructive trust could attach. Plaintiffs cannot trace the funds that were paid for these contracts. Plaintiffs argue that the notion that funds

must be traceable and the requirement that the res be identifiable are concepts of purely historical interest today, at least in the enlightened states of Wisconsin, Minnesota and Texas. There are decisions that support this contention of the plaintiffs, at least in certain contexts. However, it is a federal question whether a trust, whether express or constructive, which cannot be traced to specific assets, will attach to the creditors' general funds *in bankruptcy*.

In *U.S. v Randall*, 401 U.S. 513, 91 S.Ct. 991 (1971) the Court held that the Bankruptcy Act is an overriding expression of federal policy which precludes the imposition of a constructive trust in favor of the I.R.S. against bankruptcy assets, even where the ingredients for a constructive trust are present.

In *Elliott v. Bumb*, 9 Cir. 1966, 356 F.2d 749, 754-755, cert. den. 385 U.S. 829, 87 S.Ct. 67, 17 L.Ed.2d 66 (1966), a California vendor of money orders became bankrupt. A California statute required that the vendor segregate all payments received and, if the vendor failed to do so, the statute impressed a statutory trust on all funds of the vendor needed to honor the money orders. The bankrupt did not segregate enough and the court held that the holders of the money orders in excess of traceable funds were general creditors of the bankrupt and were entitled to no priority or other special consideration ahead of any other creditors.

The court concluded that the state statute insofar as it undertook to impress a lien upon general funds of the debtor, in effect, created a statutory lien in favor of a particular class of creditors. Section 67c(2) of the Bankruptcy Act has invalidated all statutory liens, except rent. Section 64a(1)-(5) explicitly orders the priorities. The Supremacy Clause requires that conflicting state law give way to these provisions.

The court quoted and followed a similar statement of the rule announced at 4A *Collier on Bankruptcy* (14th

ed.) Section 70.25(2).

This decision is controlling in our cases. There is no reason that a constructive trust which is imposed by State case law, assuming that to be the situation here, would warrant a different conclusion from that reached in *Elliott*, which dealt with an express trust imposed by State statute. In the words of the court:

> "If state law is contrary to federal bankruptcy law, the state law must yield. Giving effect to the provisions of Section 12300.3, which would impress a trust upon commingled funds, would open the door to state creation of priorities in favor of various classes of creditors by labeling such priorities as 'trusts'. This would tend to thwart or obstruct the scheme of federal bankruptcy."

Elliott was followed in *Lusk Corp. v. Arizona State Tax Commission*, 9 Cir. 1972, 462 F.2d 187, dealing with income taxes withheld but not segregated and not traceable. It was also followed in *Matter of Faber's* D.Conn. 1973, 360 F.Supp. 946, 948 dealing with a rug company which diverted the deposits of customers made for rugs promised but not delivered. The court recognized that a constructive trust, at least in Connecticut must be based upon "fraud, actual or constructive" and it was unlikely that this element was present, but even if it were, the court concluded:

> "The courts have consistently treated the distributional priorities created by the Bankruptcy Act as a paramount congressional policy which must predominate in the face of conflicting state or even federal law."

It then cites and follows *United States v. Randall*, *Elliott v. Bumb*, and 4A *Collier on Bankruptcy* (14th ed.) Sec. 70.25(2) pp. 363-364 reviewed above.

Those portions of the three complaints filed for customers in Wisconsin, Minnesota and Texas which seek to impress a trust in favor of certain purchasers of maintenance contracts are dismissed without leave to amend and with prejudice.

The three complaints remain pending for further proceedings solely upon allegations that the trustee received and wrongfully disposed of lay away merchandise paid for in full to the bankrupt by members of the plaintiff classes, and that the trustee received and wrongfully disposed of articles left with the bankrupt for repairs.

Counsel are directed to be before the court for a conference on *Monday, May 16, 1977 at 9:30 A.M., in Room 810 Ainsley Building, 14 N.E. First Avenue, Miami, Florida,* to fix a date for trial on the remaining issues.

DONE and ORDERED at Miami, Forida, this *5th* day of May, 1977.

Thomas C. Britton
Bankruptcy Judge

Copies furnished to:

Jonathan P. Siner, Esquire
Alan A. Held, Esquire
Roger J. Schindler, Esquire
Jack D. Wilson, Esquire
Robert G. Hewitt, Esquire
Melvin Reese, Trustee

Supreme Court, U. S.
FILED
SEP 2 1980
MICHAEL RODAK, JR., CLERK

CASE NO. 79-1884

in the

Supreme Court of the United States

OCTOBER TERM, 1979

STATE OF WISCONSIN,
STATE OF MINNESOTA,
STATE OF TEXAS, and certain designated classes of consumers,

Petitioners,

v.

MELVIN REESE, a trustee in bankruptcy for KENNEDY AND COHEN, INC., and related subsidiary corporations, bankrupts,

Respondent.

On Petition for Writ of Certiorari To The United States Court of Appeals For the Fifth Circuit

BRIEF FOR RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether, as contemplated by U.S. Sup.Ct. Rule 19, 28 U.S.C.A. 37, there is any special or important reason for granting a review.

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BRIEF FOR RESPONDENT IN OPPOSITION

STATEMENT OF THE CASE

The essential facts are set forth in the Partial Summary Judgment entered in the Bankruptcy Court (App. at A-12 to A-14). While not necessarily relevant, the additional facts set forth in the Petition were probably supported by the record below except for the assertion on Page 8 of Petitioners' Brief that:

> "Kennedy and Cohen did not set aside the preventive maintenance proceeds or any other funds or take any other measures to assure the performance of their service policy obligations."

While no funds were set aside, Kennedy and Cohen did use portions thereof to establish and maintain maintenance departments at various locations in several states, and in connection therewith, purchased and installed equipment, purchased repair parts and vehicles, made payroll of maintenance personnel and complied with the terms of the preventive maintenance contracts up until the date of bankruptcy.

ARGUMENT

A. No Constructive Trust Under State Law

In the Partial Summary Judgment, the Bankruptcy Judge clearly ruled that the Plaintiffs had failed to prove facts that would give rise to the establishment of a constructive trust under the laws of Texas, Minnesota, Wisconsin or any other state (App. at A-13 and A-14). Kennedy and Cohen had no duty under state law to set

up escrow or trust accounts for consumers. Accordingly, there was no wrongful act giving rise to a constructive trust. No assertion has been made by the Petitioners that the Court of Appeals, in affirming the lower courts, decided an important state question in a way to conflict with applicable state laws. No conflicting state law in this regard was cited, nor apparently does any exist.

Even though the Petitioners did not prove sufficient facts to impose a constructive trust under the laws of their respective states, they are petitioning this Court to consider whether bankruptcy law or state law should govern as to the extent of assets over which a constructive trust should be imposed.

B. Bankruptcy Law Controls Over State Law as to the Extension of a Constructive Trust to Unrelated Assets

If it is assumed, contrary to the facts, that a constructive trust would exist under the laws of the state of one of the Petitioners, then the question presented is whether, at some point, bankruptcy law should govern over other conflicting state law as to the extent of the bankruptcy assets over which the constructive trust may be imposed. The courts in *In re Faber's, Inc.*, 360 F.Supp. 946 (D.C.Conn. 1973), *Lusk Corporation v. Arizona State Tax Commission*, 462 F.2d 187 (9th Cir. 1972), and *Elliott v. Bumb*, 356 F.2d 749 (9th Cir. 1966), *cert. denied*, 385 U.S. 829 (1966), followed this Court's guidance in *United States v. Randall*, 401 U.S. 513 (1971), in recognizing that the Bankruptcy Act is an overriding expression of federal policy in this regard.

Respondent readily admits that this Court has recognized that a constructive trust imposed by state law will be recognized as to specific assets vested in a bankruptcy trustee. In this case, however, the Petitioners were unable to trace any assets, even with the presumptions recognized in *Cunningham v. Brown,* 265 U.S. 1 (1924). In lieu thereof, the Petitioners maintained that their inability to trace funds require the imposition of a constructive trust on all assets vested in the Trustee in Bankruptcy. No applicable state law affords them such a remedy. More importantly, there is no conflict between the decisions in *Cunningham v. Brown, supra,* and *United States v. Randall, supra,* or the cases decided thereunder. The cases relied upon by Petitioners, including *Cunningham,* relate to the tracing of funds to a bank account and not with the establishment of a trust where funds cannot be traced under any circumstances.

C. The Bankruptcy Act Has Been Replaced

The Bankruptcy Act of 1898, Ch. 541, §1 et seq., 30 Stat. 544 (1898) [Codified in 11 U.S.C. §101 et seq. (1970) (repealed 1979)], has been replaced in cases commenced after October 1, 1979, by the Bankruptcy Reform Act of 1978, 11 U.S.C. §101 et seq. (1979). Although no distinction was made between consumers and commercial creditors under the Bankruptcy Act, consumers are given a priority claim under the Bankruptcy Reform Act of 1978. *See Bankruptcy Code 11 U.S.C. 403(a)(5).* Although many cases are still pending that were commenced prior to October 1, 1979, their number and importance are dwindling. It is doubtful that a decision by this Court would substantially affect the rights of consumers in other pending cases.

Although not an issue here, at some time this Court will be asked to decide whether the priority given consumers under the Bankruptcy Reform Act supersedes the right of a consumer under state law to establish, in an appropriate case, a constructive trust over assets in the hands of a Debtor or Trustee.

CONCLUSION

The Petitioners did not establish their right to cause a constructive trust to be imposed upon assets vested in the Trustee in Bankruptcy. As recognized by the Bankruptcy Judge, it is the Plaintiffs' burden to establish some wrongdoing on the Bankrupt's part, either in obtaining funds or in retaining them (App. at A-13). The Plaintiffs could cite no state law that would have required Kennedy and Cohen to segregate or place in trust payments made by its customers on account of preventive maintenance policies.

The Petitioners admitted below that funds paid to Kennedy and Cohen could not be traced, and they made no effort to utilize presumptions in their favor to do so. Rather, they sought the imposition of a constructive trust upon all assets in the hands of the Trustee, including those encumbered by various security interests.

The question of whether bankruptcy law or state law should govern is academic in this instance since there is no basis under either law to sustain the contentions of the Petitioners. The lower courts properly relied upon the bankruptcy law to defeat the contention of the imposition of a general trust upon all assets. They

were not concerned with the extent to which an alleged trust beneficiary must trace funds into a bank account, since it was conceded that the funds could not be traced.

While the courts and legislatures of the various states have not seen fit to give consumers a preferred status over commercial creditors, the Bankruptcy Reform Act has now done so, thus leaving the absence of such distinction under the Bankruptcy Act of little public importance.

Accordingly, the Petition for a Writ of Certiorari before the United States Court of Appeals for the Fifth Circuit should be denied.

Respectfully submitted,

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